

## FAST FACTS

- ◆ Credit scoring is a system used by some creditors to determine whether to give you a loan or credit card.
- ◆ To develop a system, a creditor will use statistical methods to identify and weigh characteristics based on how well each predicts who would be a good credit risk.
- ◆ With credit scoring systems, creditors are able to evaluate millions of applicants consistently and impartially on many different characteristics.

How does a creditor decide whether to lend you money for such things as a new car or a home mortgage? Many creditors use a system called "credit scoring" to determine whether you are a good credit risk. Based on how well you score, a creditor may decide to extend credit to you or turn you down. The following questions and answers may help you understand who gets credit, and why.

## WHAT IS CREDIT SCORING?

Credit scoring is a system used by some creditors to determine whether to give you a loan or credit card. The creditor may examine your past credit history to evaluate how promptly you pay your bills and look at other factors as well, such as the amount of your income, whether you own a home, and how many years you have worked at your job. A credit scoring system awards points for each factor that the creditor considers important. Creditors generally offer credit to those consumers awarded the most points because those points help predict who is most likely to pay back the debt.

## WHY IS CREDIT SCORING USED?

In smaller communities, shopkeepers, bankers, and others who extend credit often knew by word of mouth who paid their debts and who did not. As some creditors became larger and as the number of their consumer credit applications grew, these creditors needed to establish more systematic and efficient methods for evaluating which consumers were good credit risks. Credit scoring is one such technique.

Although smaller creditors still may rely on informal credit evaluations, many large companies now use formal credit scoring systems. Although no system is perfect, credit scoring systems can be at least as accurate as informal methods for granting credit -- and often are more so -- because they treat all applicants objectively.

## HOW IS A CREDIT SCORING SYSTEM DEVELOPED?

Most credit scoring systems are unique because they are based on a creditor's individual experiences with customers. To develop a

system, a creditor will select a random sample of its customers and analyze it statistically to identify which characteristics of those customers could be used to demonstrate creditworthiness. Then, again using statistical methods, a creditor will weigh each of these factors based on how well each predicts who would be a good credit risk.

## HOW IS A CONSUMER'S APPLICATION SCORED?

To illustrate how credit scoring works, consider the following example that uses only three factors to determine whether someone is creditworthy. (Most systems have 6 to 15 factors.)

Example:

FACTORS	POINTS	FACTORS	POINTS
<b>MONTHLY INCOME:</b>		<b>AGE:</b>	
Less than \$400	0	21-28	11
\$400 to \$650	3	28-35	5
\$651 to \$800	7	36-48	2
\$801 to \$1,200	12	48-61	12
\$1,200 +	15	61 +	15
<b>TELEPHONE</b>			
in Home			
Yes	12	No	0

Some credit scoring systems award fewer points to people in their thirties and forties, because these individuals often have a relatively high amount of debt at that stage of their lives. The law permits creditors using properly-designed scoring systems to award points based on age, but people who are 62 or older must receive the maximum number of points for this factor.

If, for example, you needed a score of 25 to get credit, you would need to make sure you had enough income at a certain age (and, perhaps a telephone) to qualify for credit.

Remember, this example shows very generally how a credit scoring system works. Most credit scoring systems consider more factors than this example -- sometimes as many as 15 or 20. Usually these factors are obviously related to your credit worthiness. Sometimes, however, additional factors are included that may seem unusual. For example, some systems score the age of your car. While this may seem unrelated to creditworthiness, it is legal to use factors like these as long as they do not illegally discriminate on race, sex, marital status, national origin, religion, or age.

## HOW VALID IS THE CREDIT SCORING SYSTEM?

With credit scoring systems, creditors are able to evaluate millions of applicants consistently and impartially on many different

characteristics. But credit scoring systems must be based on large enough numbers of recent accounts to make them statistically valid. Although you may think that such a system is arbitrary or impersonal, a properly developed credit scoring system can make decisions faster and more accurately than an individual can. And many creditors design their systems so that marginal cases -- not high enough to pass easily or low enough to fail definitively -- are referred to a credit manager who personally decides whether the company will extend credit to a consumer. This may allow for discussion and negotiation between the credit manager and a consumer.

## WHAT HAPPENS IF YOU ARE DENIED CREDIT?

While a creditor is not required to tell you the factors and points used in its scoring system, the creditor must tell you why you were rejected for credit. This is required under the federal Equal Credit Opportunity Act (ECOA).

So if, for example, a creditor says you were denied credit because you have not worked at your current job long enough, you might want to reapply after you have been at that job longer. Or, if you were denied credit because your debt-free monthly-income was not high enough, you might want to pay some of your bills and reapply. Remember, also, that credit scoring systems differ from creditor to creditor, so you might get credit if you applied for it elsewhere.

Sometimes you can be denied credit because of a bad credit report. If so, the Fair Credit Reporting Act requires the creditor to give you the name and address of the credit reporting bureau that reported the information. You might want to contact that credit bureau to find out what your credit report said. This information is free if you request it within 30 days of being turned down for credit. Remember that the credit bureau can tell you what is in your report, but only the creditor can tell you why it denied your application.

## WHERE CAN YOU GO FOR MORE INFORMATION?

This JavaScript calculator will "score" your credit using the number of late payments you have on various credit accounts. This isn't a true "credit score," but will give you a pretty good idea of how you'd fare.

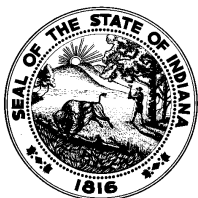
If you have additional questions about credit scoring issues, write to: Correspondence Branch  
[Federal Trade Commission](#)  
Washington, D.C. 20580

While the FTC cannot resolve individual problems for consumers, it can act when it sees a pattern of possible law violations.

The Indiana Department of Financial Institutions, Division of Consumer Credit has many other credit related brochures available, such as:

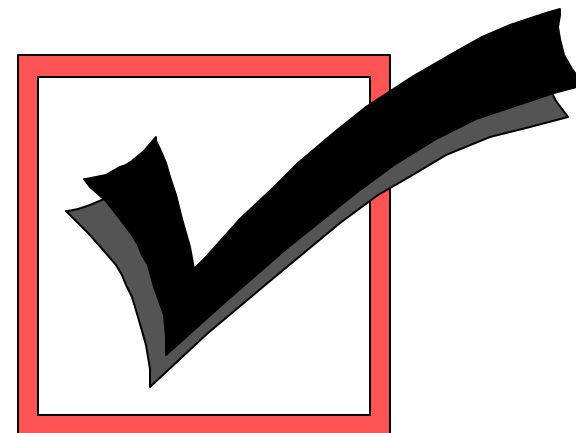
Answers to Credit Problems  
Applying for Credit  
At Home Shopping Rights  
Bankruptcy Facts  
Buried in Debt  
Charge Card Fraud  
Choosing A Credit Card  
Co-Signing  
Credit and Divorce  
Credit Reporting and Scams  
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Fair Credit Reporting  
Fair Debt Collection  
Gold Cards  
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Reverse Mortgage Loans  
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Shopping for Credit  
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What is the DFI?

Call our toll-free number or write to the address on the cover for a copy of any of the brochures listed or for further consumer credit information.



DEPARTMENT OF FINANCIAL INSTITUTIONS  
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# SCORING FOR CREDIT



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